TESTIMONY OF
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Mr. Chairman and Distinguished Members of the Committee, I am pleased to discuss the IRS' 2001 tax filing season, our FY 2002 budget request and the initiatives we are undertaking on behalf of America's taxpayers.

INTRODUCTION: A PLAN FOR TODAY AND THE FUTURE

Mr. Chairman, last year when I came before you, I said we had a clear direction and had taken some important steps to improve the IRS. Now, for the first time I can tell you that we have a real plan that lays out how we will build on the foundation we have laid to make the IRS everything the American public has a right to expect it to be.

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the letter and spirit of the IRS Restructuring and Reform Act of 1998 (RRA 98) and reflects the new and modernized IRS. The strategic plan shows how the IRS can dramatically improve service to taxpayers and ensure fairness and compliance with our tax laws. Moreover, the Agency will meet these goals while continuing to shrink in size relative to the economy.

The greatest challenge presented by the IRS strategic plan is that we must continue to administer the world's largest and most complex tax system while simultaneously reengineering and improving how the Agency works at its most basic level. In other words, we must operate effectively and modernize at the same time.

Mr. Chairman, I want to emphasize the importance of this two-pronged, or dual approach of strategies to improve performance over the next two years while modernizing the Agency in the longer term. Let me illustrate how this approach is now working. In conjunction with our mission and goals, we developed 10 major strategies. For each of these strategies, operational priorities and improvement projects for FY 2001 and 2002 were defined and responsibilities assigned for carrying them out. Some of our major strategies include:

> ***Meet the Needs of Taxpayers.*** Each year, the IRS has millions of interactions with taxpayers who need information or assistance to file their returns or pay what they owe. The taxpayer should always receive quality service from the IRS that is helpful based on his/her particular situation and need. Taken together, the fundamental changes underway in all aspects of our operations will provide taxpayers accurate and prompt information to assist them in filing, paying, and resolving issues in a time and manner convenient for them. In the short-term, we will implement this strategy

through actions such as expanding phone-hours, adding more convenient locations and providing additional assistors during peak hours.

Reduce taxpayer burden. One of the themes underlying improved IRS's business practices is to shift from addressing taxpayer problems well after returns are filed to addressing them early in the process, and in fact preventing problems wherever possible. Over the next two years, we will make substantial progress to reduce taxpayer burden although much more will be possible through our longer-term business system modernization efforts. Increasing our partnerships with states and practitioners will be a major part of this strategy. In the short-term, we can make improvements, such as expanding our Voluntary Compliance Agreement Program and providing specific information over the Internet to taxpayers groups. The new IRS "Small Business Self-Employed Community" web page is an excellent example of this strategy.

Broaden the use of electronic interactions. Electronically-filed returns improve service for taxpayers and boost productivity by reducing errors, speeding refunds, and reducing labor costs. We will enhance technology to allow filing of a full range of returns, eliminate requirements for separate signature documents, tailor marketing and education programs to attract taxpayers and practitioners with varying needs, and broaden the number of payment options. Customer education and assistance programs provided through the IRS web site, such as the distribution of forms and publications and answers to tax law questions, are growing rapidly. We are making excellent short-term progress on this strategy. Examples include the elimination of paper signatures for *e*-filed returns and dramatically increasing the number of forms that can be filed electronically.

Address key areas of non-compliance. Research indicates that there are major non-compliance problem areas. These include abusive tax shelters and trusts as vehicles for managing assets and for wealth transference. Unpaid employment and withholding taxes by businesses have also increased and overpayment of refunds due to erroneous return claims is high. We will make progress in combating key areas of noncompliance over the next two years as demonstrated by our recent actions on illegal offshore trust programs. In 2002, the IRS will change its processing procedures and begin processing and matching K-1s (schedules filed by partnerships, trusts and S-corporations to provide information on income/losses distributed by business entities, to individual partners, beneficiaries and shareholders).

Stabilize traditional non-compliance areas. Regardless of how successful we are in preventing taxpayer errors, intervention through examination and collection actions and investigations is necessary when noncompliance or non-payment is found or suspected to be occurring. Since we have limited resources, it is essential that we apply these resources where they will be of most value. More focused and rapid intervention can enormously improve the effectiveness and efficiency of our activities, while improved case management tools can improve the quality and speed of cases and ensure that taxpayer rights are observed. The recent funding of the STABLE

(Staffing Tax Administration for Balance and Equity) initiative is key to the IRS stemming and turning around the decline in collection and exam activities.

These major compliance improvements will require, however, a fundamental redesign of our most complex business processes. They are also very dependent on new technology from our Business Systems Modernization program (BSM). Therefore, our strategy is to stabilize and improve traditional compliance programs in the near term, while working through BSM for long-term and fundamental improvements.

Over the past year, the IRS also made steady progress on three key modernization programs. In response to RRA 98, the new customer-focused organization is currently being implemented, and a top management team is in place for each of the four Operating Divisions and functional units. We also approved balanced measures for much of the new organization and have slated approval of measure for the remaining organizational units for the current fiscal year. Both of these programs should start delivering benefits now.

The third piece of modernization, the Business Systems Modernization program (BSM) is off to an excellent start. The Enterprise Architecture plan, which is the roadmap for modernizing the Agency's business systems and supporting information technology networks, was approved earlier this year. BSM is just beginning to deliver tangible improvements; it will deliver a growing number of benefits with each succeeding year for the remainder of the decade. Each of these programs is discussed in detail later in the testimony.

Mr. Chairman, I want to stress that this dual approach will require sustained support from the Congress and the public, as the change will take time and will inevitably include setbacks along the way. It will also require investments, especially for business systems modernization, and adequate funding for current operations, such as customer service and compliance.

PROGRESS MADE: INITIAL SUCCESSES UPON WHICH TO BUILD

Mr. Chairman, I would like to discuss some of the progress the IRS has made over the past year, particularly as it relates to how we are making it easier for all taxpayers to file their returns and pay their taxes and how we are ensuring the fairness of our tax administration system.

Checkbox Initiative

Beginning this filing season, Paid Return Preparers can use the Third Party Authorization Checkbox on all Form 1040 Series returns with the exception of TeleFile. This checkbox indicates the taxpayer's desire to allow the IRS to discuss the tax return and attachments with the preparer while the return is being processed. This provides for a significant reduction in paperwork for millions of taxpayers. It also addresses a problem with which we have been grappling for years.

Including a checkbox on the family of 1040 returns is a direct response to requests from our external stakeholders, such as the South Florida Citizen Advocacy Panel (CAP), National Society of Accountants, National Association of Tax Practitioners and National Association of Enrolled Agents.

The checkbox designation should enable practitioners quickly to resolve questions concerning the processing of the taxpayer's return. It should also reduce the number of contacts necessary to resolve processing questions and eliminate the need for the submission of paperwork for a Power of Attorney, which is not required to resolve simple problems with a taxpayer's account. Our initiative also addresses the practitioner groups' concern that this designee not be afforded post-assessment correspondence or representation.

Mr. Chairman, the IRS calculates that taxpayers will save an estimated 75,000 hours initially by not having to prepare a third party authorization disclosure form (Form 8821). Additional time will be saved because processing issues will be resolved immediately, thereby eliminating unnecessary post-filing contacts. However, we recognize that the net burden reduction, as currently calculated, will be somewhat smaller because there will be an increase in burden for reading and understanding Forms 1040 instructions for the new checkbox authority.

We further expect over a million taxpayers to use the checkbox feature in lieu of filing Form 2848 (Power of Attorney and Declaration of Representative). Therefore, taxpayers will save an estimated 1.9 million hours initially by not having to prepare Form 2848. Once again, the net burden reduction will be less because we must assume there will be an increase in the burden for reading Forms1040 instructions and understanding the new checkbox authority.

The burden reduction that will result from the checkbox initiative is even greater when one considers the 8 million notices related to math errors and return preparation that were issued in 2000. Twenty-seven percent of these notices were related to returns prepared by paid preparers. The IRS estimates that taxpayers will save approximately 779 thousand hours by referring notices to their designees rather than responding to the IRS in writing or by telephone. Similarly, we estimate that taxpayers will save more than a million hours related to correspondence by allowing IRS to resolve issues by contacting their designees.

Redesigned Notices

As part of its continued effort to improve its correspondence to taxpayers, the IRS began sending out six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets. The new notices should: (1) reduce the number of times taxpayers need to contact the IRS; (2) be easier to understand; and (3) facilitate resolution of inquiries. The combined yearly volume of these six notices is about 10.5 million.

Following RRA 98's directions, the new notices also contain more information, including: (1) the formula for how the IRS computes the penalty or interest; (2) the section of law from which the penalty or interest is based; and (3) a table that details account information under each penalty or interest section to specific periods that the charges apply. Members of the Citizen's Advocacy Panel reviewed the notices before we released them in October 2000.

Despite extensive testing, some of the first notices sent out were missing information. The IRS has since corrected errors in the programming for these notices and mailed explanations to taxpayers as appropriate.

We are continuing our redesign efforts on 23 additional notices. We plan to release four of the notices in 2002 and the remaining 19 in 2003.

Change of Address

Due to a licensing agreement between the IRS and the U.S. Postal Service, taxpayers who move after filing their tax returns should receive future correspondence from the IRS on a more timely basis.

Under this arrangement, the IRS will use the Postal Service's National Change of Address (NCOA) database to update the addresses in its own Master File of taxpayer data. This address updating process should also provide quicker resolution of undelivered refund problems.

The IRS will check the names and old addresses in the NCOA weekly update files against the names and addresses in the IRS database. Where there is an exact match, the IRS will update its file with the taxpayer's new address. According to the Postal Service, there are about 800,000 address changes each week.

In addition to helping IRS get refunds to taxpayers, this new program will permit the IRS to make earlier contacts with them to resolve issues such as delivery of a returned refund, possible unreported income, examination of a return, or collection of unpaid tax. The delay in delivery that can result from a letter going to an old address, then being forwarded, may cause a taxpayer's reply and a subsequent IRS letter to cross in the mail. Unraveling such situations can be time-consuming and frustrating for both the taxpayer and the IRS.

Stabilization of Compliance Activities

Earlier this year, Congress approved the staffing plan for the STABLE (Staffing Tax Administration for Balance and Equity) initiative. The funding was included in the Fiscal 2001 Appropriations bills.

The STABLE staffing plan reflects the new modernized IRS and represents a careful judgment as to how these additional resources, together with our internal management improvements, can best be used to improve our service to taxpayers and compliance effectiveness.

The two principles that guided the budget request were, first, allocate incremental resources directly to staffing front line positions. Second, these additional resources will provide a balanced improvement between service and compliance programs. With the increased staffing levels, we expect the IRS to be able to slightly increase levels of service and to stabilize the level of exam and collection activity while complying with the taxpayer rights provisions of the RRA.

Our overarching goal is to achieve the greatest possible improvements in both taxpayer service and compliance efforts by determining how best to use the STABLE resources in conjunction with the base FY 2001 budget request. We believe that STABLE achieves this goal.

In our reorganization effort over the last two years, we have carefully studied the use of nearly every position in the IRS. One of the key findings in this analysis is that the use of compliance personnel such as revenue agents and revenue officers on "details" to taxpayer service duties during the filing season is not efficient. This practice, while necessary as a short term solution to inadequate service, takes highly trained and high graded personnel away from important exam and collection casework during a substantial part of the year, causing reduced levels of productivity and delays in completing cases.

Another key finding of the study is that the IRS provided very minimal levels of activity in assisting taxpayers to understand their tax obligations and avoid mistakes in filing, especially in the small business areas. Many stakeholders groups have stressed that this problem causes errors later in the process, which are expensive for both taxpayers and the IRS.

In our new structure, instead of increasing the number of expensive and scarce compliance personnel, we have provided for additional positions in taxpayer service and education. A significant portion of the STABLE resources will be used to fill these positions. By hiring staff to perform these service and educational functions, we can avoid the need to use more expensive compliance personnel on details during the filing season, thus allowing us to accomplish two objectives efficiently: increase our level of taxpayer education and taxpayer service and increase the number of staff years actually applied to exam and collection casework.

With this approach to the STABLE staffing, together with our reorganization and technology improvements, we expect to show measurable improvements in our key programs in FY 2001. Because of the time required to hire and train people, we will not achieve the full impact until FY 2002. Some of the improvements we expect in key areas in FY 2001 are:

- Increase the level of service on our toll free telephone service from approximately 59.1 percent in FY 2000 to approximately 63.4 percent in FY 2001, while also improving our quality measures.

- Reverse the downtrend of the last five years in compliance, increasing the number of overdue accounts closed by our telephone and field collectors by 8.6 percent.

- Increasing the number of exams of individuals conducted in person by about 6.2 percent, while also improving quality.

In examination, we will focus on the areas with the greatest risk of underreporting of income. For example, the number of exams of higher income individuals and corporations will increase more rapidly than the average.

This additional staffing will allow us more quickly to resolve innocent spouse claims, offers in compromise cases and collection due process cases we completed – key taxpayer rights included in RRA 98. We will also increase our commitment to pre-filing assistance to taxpayers through communication and education programs and pre-filing agreement programs. These areas are of particular importance and concern for the small business community.

Targeting Our Resources

We must promote fairness by combating key areas of non-compliance. To this end, the IRS must apply its limited resources where they will be of the most value. Some of the special problem compliance areas include: underreporting, non-filing and abuse of trusts and passthroughs; abusive corporate tax shelters; accumulations of unpaid trust fund taxes; and erroneous refund claims.

Abusive corporate tax shelters continue to be an important compliance initiative for the IRS. From the information that IRS and Treasury receives from a variety of internal and external sources, we know that there are a significant number of transactions that have no legitimate business or economic purpose other than reducing taxes.

These abusive corporate tax shelters could seriously undermine the tax system if all corporations believe they must engage in these transactions to keep up with the competition.

We have a coordinated effort with Treasury to deal with this problem and our Office of Tax Shelter Analysis (OTSA) plays an important role in it. The IRS does not want to impede normal tax planning, and through the OTSA, we have available a means to separate the real problems from quite legitimate transactions. In addition, a "Tax Shelter Hotline" and our commitment to issue more guidance in this area will help us respond to abusive transactions on a more timely basis.

Promoters of abusive tax shelters are also using offshore tax entities in their tax schemes to unlawfully reduce or eliminate taxes. Last month, in the largest IRS enforcement action ever taken, law enforcement authorities in multiple states executed over three dozen search warrants and made four arrests as part of a series of investigations of alleged illegal offshore trust programs involving the diversion of millions of dollars of income for hundreds of clients.

I want once again to express my appreciation for the fine work done by our Criminal Investigation Division, the United States Attorneys offices in Boston and San Francisco, the Tax Division of the Department of Justice, and the Costa Rican law enforcement authorities. Last week's historic enforcement activities send an unmistakable signal about IRS' commitment to pursue investigations of promoters and their clients who would try to move money off-shore to evade taxes.

It further represents the IRS' continuing efforts to combat tax compliance problems caused by those who promote and participate in the use of trusts and offshore schemes designed to evade U.S. taxes.

Frauds Alerts: Buyer Beware

In February 2001, The Internal Revenue Service issued a nationwide alert to taxpayers, warning them not to fall victim to a number of tax scams that are being promoted. These schemes take several shapes, ranging from promises of special tax refunds to illegal ways of "untaxing" yourself. Taxpayers were told that they could report suspected tax fraud to the IRS by calling 1-800-829-0433.

One of these illegal tax schemes involves telling employers that they do not have to withhold federal income tax or employment taxes from the wages paid to their employees. Using a bogus interpretation of the Tax Code, the con artists are selling the unsuspecting and the unscrupulous a phony and illegal scheme that in the long run will cost these employers a huge tax bill that can include stiff penalties and jail time.

In addition to this warning, the IRS devoted a special consumer alert to this problem. We told working men and women that if they have concerns that their employer is failing to withhold these taxes to call our toll-free number at 1-800-829-1040. We are also asking our stakeholder groups to help us get the word out about this problem.

Taxpayers can get more information on how the IRS is combating this bogus withholding scheme by going to our web site at www.irs.gov and clicking on the "Small Business and Self Employed Community" page. From there, taxpayers can click on "tax schemes" and get all the necessary information. Taxpayers can also link to the IRS' Criminal Investigation home page and get a very detailed description of its employment tax enforcement program, including a breakdown of cases and a number of significant convictions of those who thought they could get away with evading their tax responsibilities.

I want to stress that IRS Criminal Investigation works closely with all parts of the Agency to investigate and refer for prosecution individuals and companies who have willfully failed to file or pay employment taxes. In the past three years, 127 individuals were sent to federal prison, a halfway house or home detention on employment tax issues. Nearly 86 percent of those sentenced for evading employment taxes served an average of 17 months in confinement and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

Revenue Protection Strategy

The IRS revenue protection efforts in 2001 will again identify and look at certain tax returns before issuing refunds. In addition to identifying questionable refunds, the IRS will continue its emphasis on improving compliance with the Earned Income Tax Credit (EITC) provisions of the Internal Revenue Code, including the use of our dependent database to identify questionable issues relating to incorrect claims on dependent exemptions, filing status and EITC credits.

The Earned Income Tax Credit Preparer Outreach Program will also continue. As part of this program, IRS revenue agents will visit tax professionals nationwide prior to January 2001, to provide individual assistance and to answer any questions about EITC. Some of the visits will also include a review of files to determine if due diligence requirements for the preparation of EITC have been met.

2001 Filing Season

The IRS is delivering a very successful filing season as it continues to meet the mandates that Congress set forth in RRA 98 and the challenges of modernization.

By continually managing this change and risk in an orderly and integrated fashion, I am pleased to report that as we approach the home stretch, the 2001 tax filing season has been smooth and almost error free. The 2001 filing season continues to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect.

Projected net collections for FY 2001 will exceed the $1.9 trillion collected last year. During FY 2001, we also project to receive 215.4 million returns, including over 130.3 million individual returns, and expect to issue over 96.8 million individual refunds. As of March 9, 2001, the average dollar amount per refund is up over 5 percent over last year, and the average refund is $1,823.

Electronic Tax Administration

Mr. Chairman, RRA 98 mandated that at least 80 percent of returns be filed electronically by 2007. Reaching this and the other Electronic Tax Administration (ETA) goals is an enormous challenge, but well worth the effort.

The IRS' overarching goal is to conduct most of its internal and external transactions by electronic means. To meet this objective, we must make it not only technologically possible, but also attractive to the public to make a permanent change from paper to electronic means. Indeed, a robust ETA system helps form the foundation of a modernized IRS. It is key to easing taxpayer burden and can provide multiple benefits to taxpayers, practitioners and our tax administration system.

Let me also stress that during the past year, the IRS completed a sweeping set of changes and upgrades to add an extra layer of protection for the millions of taxpayers using the *e*-file program. We have strengthened our system's security and we will remain vigilant to keep our *e*-filing processes the safest possible.

The 2001 filing season statistics continue to demonstrate that an increasing number of taxpayers are taking the advantage of these initiatives and filing taxes electronically. Through March 15, 2001, over 29.3 million individual taxpayers filed using one of the three *e-file* options*;* a 10 percent increase over the same period last year.

- Nearly 21.7 million taxpayers *e-filed* their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), an 11.2 percent increase over the same period last year.

- Approximately 4.2 million taxpayers filed their tax returns on-line via their home computer through a third party transmitter. On-line filing is running 37 percent ahead of last year and as of March 15, is already approaching the 2000 total volume of 5 million.

- Almost 3.5 million taxpayers filed their returns over the telephone using the award winning TeleFile system. Oklahoma and Georgia joined Kentucky and Indiana in the Federal/State TeleFile option.

- Overall, 11 million taxpayers chose to file both their federal and state tax returns simultaneously in a single electronic transmission. This year, 35 states and the District of Columbia are participating in the program.

Mr. Chairman, let me also note that paper and electronic return preparation and filing are also offered through IRS local offices as well as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. Taxpayers who cannot afford either to pay a professional tax preparer or buy a personal computer and tax software may also go to local IRS offices to have their returns prepared. The tax software we use in our offices is competitively procured in the open market. Through this method, the IRS both electronically prepares and files simpler returns for lower-income taxpayers at their request.

New in ETA for the 2001 Filing Season

In order to improve our ETA program and ease taxpayer burden, the IRS listened to taxpayers, industry and practitioners. We heard that we must make electronic filing more attractive and remove barriers. Let me briefly discuss our efforts this filing season to meet these concerns.

First, the IRS is working to address the frustration that taxpayers and practitioners experience when they find they cannot file some forms electronically. For the 2001 filing season, we added 23 additional forms to the 1040-*e-file* program. These include Form 2106-EZ for un-reimbursed employee business expenses; the Form 2688 application for additional extension of time to file; and Form 8379 for injured spouse claims.

We plan to roll out the remaining 38 forms and schedules for the 2002 filing season. This means we will open *e-file* eligibility to 99.1 percent of all taxpayers, potentially adding 3.8 million new *e-filers* to the growing rolls. Equally important, it means that preparers will be able to go essentially 100 percent electronic for all of their customers by 2002.

Second, the IRS is making electronic filing paperless by eliminating the requirement for a separate paper document with the *e-file* return. In 2000, the IRS successfully tested the use of a Personal Identification Number (PIN) code as the taxpayer's signature, eliminating the need to file the paper *jurat*. This year's program extended the option to taxpayers nationwide, with some exceptions, and permits them to select a PIN, and then file electronically without any paper. So far, 4 million taxpayers have chosen this option.

Third, this filing season, more electronic payments options have been made available to taxpayers, such as accepting debit payments through TeleFile and accepting credit cards for Forms 1040ES, estimated tax payments, and Forms 4868, extensions of time to file. As of March 10th, 22,718 payments averaging $3,177 were made via credit card and another 24,064 payments averaging $1,026 were made by Automated Clearing House (ACH) Direct Debit where taxpayers can authorize either their checking or savings account to be debited.

Fourth, our e-Services project under BSM will help us conduct most transactions with taxpayers and their representatives in an electronic format. By 2002, the e-Services' goals are to: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

Fifth, contributing to this year's successful *e*-filing season is IRS' new marketing campaign, "40 Million People Already Know *e-file* is the Way to Go." In conjunction with its advertising agency, and as authorized by RRA 98, the IRS developed a fully integrated campaign with TV, radio and print advertising. As the *e-file* program matures, our data- and market-driven marketing campaign is shifting away from merely promoting awareness of *e-file* to emphasizing its value, such as saving taxpayers time.

ETA Also Easing Business Taxpayer Burden in 2001

A strong ETA program must embrace the needs and expectations of all taxpayers, including business taxpayers. In 2001, the IRS continues to make progress serving the electronic tax administration needs of this important sector.

For example, beginning last April, employers could file their Form 941 on line, saving time and paperwork. And for the first time, companies and payroll service provider will be able to file both the Quarterly 941 and Annual 940 (*Employer's Annual Federal Unemployment Tax Record*) electronically. A direct debit payment was also made available through Form 941 TeleFile

Another major ETA initiative eases the information-reporting burden for employers. Providers of certain information statements, including W-2s, now have the option of giving taxpayers the information electronically, instead of on paper.

These new rules were a direct response to requests we received from lenders, educational institutions, employers and stakeholders who wanted the option to deliver these statements in an electronic format. Under the new option, providers will save the cost of processing, printing and mailing paper statements. And recipients will receive the information faster and more efficiently without the worry of mailing delays or lost statements.

The Electronic Federal Tax Payment System (EFTPS) also continues to be a runaway success. In 2000, EFTPS topped all of its 1999 numbers for new enrollments, dollars and transactions. It processed more than 63 million federal tax payments – a 14 percent increase over the previous year year. And EFTPS also received a staggering $1.5 trillion – a 15 percent increase over the previous year. Payroll companies, tax practitioners and financial institutions have been instrumental in helping us grow this program and the use of electronic payments.

Why has EFTPS been so successful? Over the years, EFTPS has delivered a high level of service and accuracy. It consistently exceeds industry standards, and delivers a 99.9 percent accuracy rate for payments appropriately applied.

We developed the system with a focus on being able to handle significant volume with accuracy, integrating checks and balances to make sure information is correct and verified at each step of the process. EFTPS delivers a level of precision that can be compared to stringent banking and financial transaction standards for accuracy.

This year, we are conducting an exciting new pilot program to test our new Internet-based application for businesses to pay federal taxes on line. This new feature, EFTPS-OnLine, allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. Using EFTPS-OnLine, businesses will be able to schedule future payments through the Internet and cancel payments if necessary. They will also have access to on-line help and "how-to" pages with step-by-step instructions.

One of our primary EFTPS priorities is security and it continues with our new Internet feature. EFTPS-OnLine uses the strongest available security and encryption technology to ensure taxpayer privacy and protection. After evaluating the pilot results, we plan to make EFTPS-OnLine available to all business taxpayers and to individuals taxpayers who are required to make estimated quarterly payments.

There are currently more than 3 million taxpayers enrolled in EFTPS and with the addition of the new Internet feature, we expect that number to continue to grow.

Web-Based Help

The Internet continues to offer exciting new opportunities for easing taxpayer burden and improving service. The IRS web site, the *Digital Daily (www.irs.gov)*, has already received almost 1.3 billion hits this fiscal year. According to the "Lycos 50", since almost the beginning of the year, the IRS has consistently ranked among the top 10 user searches. As of March 21, 2000, it came in as Number 6.

Anyone with Internet access can receive: tax forms, instructions, and publications; the latest tax information and tax law changes; tax tables and rate schedules; and hypertext versions of all taxpayer information publications, including the very popular Publication 17, "Your Federal Income Tax"; all TeleTax topics; answers to the most frequently asked tax questions; a library of tax regulations; and the weekly Internal Revenue Bulletin that contains all the latest revenue rulings, revenue procedures, notices, announcements, proposed regulations and final regulations. However, to ensure that taxpayer privacy is protected, our web site will not provide or receive individual taxpayer data until adequate safeguards are in place.

Since coming on line in January 1996, taxpayers have downloaded over 412.9 million forms, publications and products. Through February 2001, there have been over 103 million downloads as compared to 51.5 million for the same period in 2000 – an increase of almost 100 percent.

The IRS web site also has a W-4 Calculator in its "Tax Info for You" section. In addition, the expanded use of online customer service technologies provides greater taxpayer access to IRS' help while on the *Digital Daily*.

Earlier this year, the IRS launched its new user-friendly "Small Business and Self-Employed Community" web page that can be accessed from our web site. It was developed by our Small Business/Self-Employed Operating Division specifically to benefit the millions of small business owners, the self-employed and start-up businesses who often confront more complex tax issues than taxpayers who have their taxes withheld by an employer.

This convenient "one-stop shopping" for assistance can provide most, if not all, of the immediate products and services that a small businessperson needs, such as a section on common problems, a calendar of important tax deadlines, helpful tax hints, forms and publications and a direct link to stakeholder sites, such as the National Association of Home Builders and the National Restaurant Association.

I mention these two associations because for the first time ever, the IRS is providing industry-specific tax information for the construction and restaurant industries. For example, if a food server wants to know the deadline for reporting tips, he or she can go to our site and in two clicks, learn that Form 4070 should be filled out and turned into the employer by February 12th.

In the near future, we will add more of these targeted areas to the web site, such as for the automotive and oil and gas industries. We will also add a Smart Q&A Wizard that will make it easier for taxpayers to search our growing database of frequently asked questions and get the information they need.

The IRS web site will continue to evolve and improve in design, content and features. The biggest leap in the future will be from its current state as an information source to include a transactional-based portal.

CD-ROMs

The Federal Tax Forms CD-ROM contains more than 600 tax forms and instructions for the current tax year, an archive of forms and instructions dating back to 1992 and some 3,000 pages of topic-oriented tax information. Users can electronically search, view-on-screen, or print any of the items contained on the CDs. The two-issue subscription is conveniently available through the *Digital Daily* for $21. If ordered by fax, mail, or telephone, the cost is $26 (includes postage and handling).

In conjunction with the Small Business Administration, the IRS also produced the latest edition of the joint small business CD-ROM, "Small Business Resource Guide: What You Need to Know About Taxes and Other Topics." It has consistently received highly favorable reviews from small businesses and external stakeholders. The Year 2001 version of the CD-ROM is being made available free of charge, one-per-customer, by calling our toll-free number at 1-800-TAX-FORM. It can also be ordered on the IRS web site.

The CD-ROM provides an array of helpful information for business operators, including actions to take before going into business and tax filing and reporting responsibilities when starting, expanding, closing and selling a business. In addition, it includes all of the business tax forms, publications and instructions for *e-filing*. The CD-ROM also allows users with Internet access to link to other helpful federal and state web sites.

Telephone Assistance

Throughout the 2001 filing season, the IRS will provide telephone assistance 24 hours a day/7 days a week at 1-800-829-1040. After April 16, we continue to offer around-the-clock service for refund and account callers, and service will be available for tax law assistance Monday through Saturday from 7:00 AM until 11 PM.

For the filing season through March 9, approximately 65 percent of the taxpayers who wanted to talk to a customer service representative got through, compared to 61.7 percent last year at this time. In addition, 10.5 million of taxpayers used our automated services to get information such as refund status, an increase of 132 percent since last year, and the trend has been upward. In the last four weeks, the level of service averaged 68.9 percent. The upward trend in phone service is encouraging and shows that our investments in training, management and technology are beginning to pay dividends. However, I concur with Treasury Secretary O'Neill's characterization of IRS's current level of phone service as "unacceptable." We still have along way to go before we can be satisfied with the quality of our phone service.

The IRS will continue to implement many process and systems enhancements to improve both the convenience and the quality of telephone communications. These changes are major, affecting approximately 14,000-15,000 employees in more than 20 locations around the country. With the benefit of new call routing technology and new software planning tools, we are realigning the work assignments and training of many of these assistors so that the employees will have the right specialized training and knowledge to answer taxpayers inquiries efficiently and accurately. We will make increasing use of the technology to direct taxpayer call more accurately to the right assistor, and enable taxpayers in many cases to make uses of "self-service" applications, either through the phone or the Internet.

As these changes take place, the average complexity of calls answered by the Customer Service Representatives (CSRs) will continue to increase as: more of the simpler calls are routed to automated services; alternative language services are expanded; and CSRs handle topics previously referred to compliance personnel.

During FY 2001, the IRS will introduce and test a new series of measures consistent with industry standards to improve monitoring of the delivery of the service experience and utilization of resources. The current measurement system will be maintained concurrent with this new effort through 2002 to allow IRS to solicit external expertise to validate and assess the new measures and develop an implementation plan. IRS will solicit external expertise to validate and assess the new measures and develop an implementation plan.

Earlier this year, the IRS also inaugurated its San Patricio, Puerto Rico call site. Now that the center is fully operational, it will be able to take the majority of the Spanish-speaking traffic. Our Spanish-speaking customer service representatives in the States will still play a critical role, but creating this center will allow us to make the best use of all of our bilingual assistors. By staffing this call site, we have made real progress in reducing the current deficit of Spanish speaking customer service representatives..

Forms By Fax and Phone

Taxpayers can receive more than 150 frequently used tax forms 7 days a week, 24-hours-a-day from IRS TaxFax. Taxpayers can request up to three items per-call. Taxpayers use their fax machine to dial the service at 703-368-9694. The only cost to the taxpayer is the cost of the call. Taxpayers can also request forms and publications by calling 1-800-TAX-FORM.

Recorded Tax Information

TeleTax has 148 topics available 24 hours a day using a Touch-tone phone. Taxpayers can call (toll-free) 1-800-829-4477 to hear recorded information on tax subjects such as earned income credit, child care/elderly credit, and dependents or other topics, such as electronic filing, which form to use, or what to do if you cannot pay your taxes. As of March 9, 2001, over 2.6 million have taken advantage of the service so far this filing season. Nearly 2.97 million taxpayers used TeleTax for the comparable period last year.

Automated Refund Information

In FY 2000, more than 13.79 million taxpayers used the Automated Refund Information system on TeleTax to check on the issuance of their refund checks. As of March 9, 2001, the number stands at over 23.8 million – up 73 percent from, last year. Taxpayers may call 1-800-829-4477 to check on their refund status Monday through Friday from 7 AM to 11:00 PM if using a touch-tone phone, or 7:30 AM to 5:30 PM for rotary or pulse service.

Taxpayer Assistance Centers

While many taxpayers prefer to use the telephone and the Internet to communicate with the IRS, our modernization studies and experience with the highly successful "Problem Solving Days" showed that some taxpayers need to meet in person with IRS representatives to get the assistance they need.

For those taxpayers who prefer to visit an IRS office, walk-in service is available at more than 400 locations nationwide. At many sites, walk-in service will be offered on 12 Saturdays between January 27 and April 14. So far this filing season, we have served over 3.37. million taxpayers at all Taxpayer Assistance Centers – a 4.54 percent decrease from last year.

The Saturday Service sites were selected based on their weekend accessibility, year-round operational status, and high traffic volume. They include non-traditional locations, such as shopping malls, community centers and post offices.

With the help of the additional personnel provided for by the STABLE initiative, we are broadening the services available in our local offices so that taxpayers who wish to come in person will be able to resolve most tax account issues. We have defined a new job category called Tax Resolution Representatives. These employees will have the training and authority to provide "one-stop service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

We also believe that by energizing the VITA return preparation program and co-locating these activities at the Taxpayer Assistance Centers, the IRS will be able to focus on simple account and collection issues. In 2001, the Stakeholder Partnership, Education and Communications (SPEC) branch of our Wage and Investment Operating Division will work with more than 17,000 volunteer sites across the country to assist an estimated 4.6 million taxpayers. We will also work to better track the impact and benefits of the volunteer program.

SERIOUS CHALLENGES REMAIN

Mr. Chairman, in spite of the progress the IRS has made since the enactment of RRA 98, it is clear that we are still not providing the level and quality of service that taxpayers deserve, nor are we collecting the taxes due efficiently.

As previously discussed, the level of phone service – while improving – is still unacceptable and not on a level with what taxpayers receive in the private sector. We cannot provide taxpayers with up-to-date information on their accounts, resulting in enormous frustration for both taxpayers and the IRS employees who want to help them. In fact, nearly all of our business processes operate too slowly, inaccurately and inefficiently. Many of our notices are still confusing and poorly written. Achieving the 80 percent electronic filing goal by 2007 will be very difficult.

The IRS is also deeply concerned about the continued drop in audit and collection activity. In fact, the GAO testified before the Senate Finance Committee in February 2000 that the current level of IRS enforcement activity is too low. Clearly, the declines we have witnessed in the past few years must stop or the fairness and effectiveness of our tax system will be undermined. The risks of these declines are not simply the dollar value of the taxes left uncollected. The greatest risk is that the average taxpayer who honestly pays taxes loses confidence if the IRS fails to act effectively and efficiently to collect from those who do not pay what they owe.

To help address these problems, the President's budget includes follow-on funding for the STABLE initiative, begun earlier this year. These funds will complete the hiring of almost 4,000 staff and will enable the IRS to address the declines in audits and the drop in customer service that have occurred over the past several years.

Mr. Chairman, the drop in exam and collection activity in FY 2000 was caused by several factors, including the long-term decline in staffing, the need to assign compliance staff to customer service duties during the filing season, and added RRA 98 responsibilities.

Between FY 1992 and 2000, the Agency's workforce fell by 17 percent while the number of tax returns filed (including supplemental documents, such as Forms 1040X, 4868,2688, 1120X and 7004) increased 13 percent to 230 million. RRA 98 also created very significant additional resource demands on the IRS Exam and Collection staffs. Expanded programs, such as the innocent spouse provisions, offers in compromise and due process in collection required more that 4,200 IRS staff annually for administration. Other provisions, such as the requirements for notifications of third parties, tacked on more time to complete each exam and collection case. More than 30 additional steps have been added to the completion of an exam.

RRA 98 also had some very profound indirect impacts on IRS operations. Two provisions, in particular, have greatly affected the time required to conduct many activities. They are: Section 1203, commonly known as the "ten deadly sins" provision, and Section 1204, which broadly prohibited use of enforcement statistics in setting goals or making personnel evaluations at any level in the IRS.

Section 1203 caused a great deal of concern, caution, and hesitation among front-line employees and their managers with respect to taking enforcement action. And Section 1204, prohibiting use of enforcement statistics, caused a great deal of confusion and hesitation among managers to use any quantitative data to evaluate operations or to direct employees with respect to matters of time and efficiency. The effect of Section 1204 has been magnified by the extensive number of investigations and disciplinary actions of managers that was undertaken in 1998 and 1999 for misuse of statistics. In addition, uncertainty over the reorganization, which flattened the organization and eliminated management layers, caused some temporary loss of focus. The effect of all these factors was to increase the time it takes to complete cases, reducing the number of cases completed per FTE by 20 to 30 percent.

In its March 2001 financial audit of the IRS' Fiscal Year 2000 Financial Statements, the GAO pointed out the continued problem with the IRS' management of unpaid tax assessments. The GAO found that the IRS' "inability to actively pursue significant amounts in outstanding taxes owed to the federal government continue to hinder IRS's ability to effectively manage unpaid assessments."

The GAO report pointed to a much larger and fundamental weakness that threatens the IRS' mission: the pressing need to overhaul IRS' systems and processes. The IRS core data systems that record taxpayers' tax accounts are fundamentally deficient. The IRS will never be able to perform its mission without replacing these systems. The solution to these problems is not simply to do more of everything in the way it has always been done. Instead the solution is to modernize the IRS to do things more efficiently and effectively.

Replacing virtually the entire technology infrastructure in the next 10 years, while also delivering short-term service improvements demanded by taxpayers, employees, and the Congress, remains an enormous challenge fraught with risk. But we have no choice; we must move ahead for the good of America's taxpayers and the good of our Nation. The President's budget includes close to $400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

Mr. Chairman, there have also been some questions as to whether the "audit rate" as publicly reported by the IRS understates the ability of the IRS to verify the accuracy of individual tax returns. Simply focusing on the audit rate does substantially understate the IRS' capacity to find errors in returns, especially in certain kinds of returns. In my many press interviews in the past few years in which this topic has come up, I have consistently made this point, often citing our computer matching program as an example of a technique that the IRS uses in addition to traditional audits.

With the use of document matching and other return verification techniques for more that will eventually be enabled by new technology, it is my view that there is no need to return to the levels of individual audit coverage that existed even five years ago, which was three times the FY 2000 level. The IRS strategic plan and budget proposals as presented to the IRS Oversight Board do not call for this approach. However, our strategic plan sets forth an approach in the short run to stabilize our level of traditional compliance activities, such as individual audits, at or slightly above current levels and to focus them on the areas where they are most required. In the long run, we will rely on our business systems modernization program to increase the effectiveness and efficiency of these activities.

The IRS has for many years relied on a range of techniques to verify certain items on tax returns. Each of these techniques is appropriate for particular classes or types of potential errors. With respect to Information Returns Processing, or document matching as it has often been called, this technique is very effective for verifying income items reported by third parties, including wages, interest, dividends and miscellaneous payments. It can also be used to verify gross sales of assets, ~~but canno~~t be used to verify the gain or loss on such sales since we have no third-party reporting on the cost basis of assets. It is also of limited value in verifying some deductions, such as mortgage interest.

Document matching is not useful for verifying business income, gain or loss on asset sales, or most itemized deductions. We estimate that the total personal income that cannot be verified by document matching represented about $1.2 trillion in FY 1998, or 19.7% of total reported personal income. An important role of audits is to verify these major categories of income and deductions.

The significance of verifying income and deduction items through audits is illustrated by the fact that the average in-person audit of an individual return results in an assessment of approximately $9,540, while the average assessment from a document matching case is $1,506. In FY 2000, the IRS closed 277,212 in-person audits of individual returns and assessed $2.4 billion from this program; in the document matching program in FY 2000, the IRS closed 1,353,545 cases and assessed $2.1 billion.

With respect the question of why document matching cases are not considered audits, the technical reason is that Section 7605(b) of the tax code generally limits the ability of the IRS to require a taxpayer to submit books and records for inspection by the IRS more than once. Since document matching cases do not require the taxpayer to submit books and records to the IRS, a document matching case does not preclude a subsequent audit. Revenue Procedure 94-68 specifically defines IRS taxpayer contacts, including document matching, which are not considered audits for the purpose of Section 7605(c). More generally, it is my understanding that some years ago the IRS proposed to change the definition of an audit to permit inclusion of the document matching cases in the overall reported number of audits and this proposal was criticized as possibly inflating IRS's statistics.

Notwithstanding these previous issues, all of IRS statistics, including the number of document matching cases, are publicly reported and it is our goal to make these reports as informative and meaningful as possible.

TURNING THE CORNER

Although overcoming these weaknesses is an enormous challenge, the IRS has achieved the first modernization milestones. If we continue to build on these initial successes, taxpayers and our tax administration system can begin to realize the benefits of modernization.

Organizational Modernization

Following RRA 98's directions, the IRS designed and has made substantial progress in implementing a new organizational structure. It closely resembles the private sector model of organizing around customers with similar needs. The IRS created four customer-focused operating divisions to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Criminal Investigation, and Communication and Liaison.

The modernized IRS organization was officially inaugurated, or "stood up", on October 1, 2000 and a top management team is in place for each of the operating divisions and business units. However, many challenges and much hard work remain as the different parts of the new organization are staffed and trained. The final stages of implementation, including the redistribution of workload, will require another two years through FY 2002.

In the short-term, the reorganization should be largely invisible to taxpayers and tax practitioners. In the long-term, they will see the positive changes that modernization is intended to produce. The new organization will place a greater emphasis on pre-filing services and early resolution of complex issues. More resources will be devoted to pre-filing activities, such as education and outreach to help taxpayers comply with the tax law and get their tax returns right the first time. Post-filing activities will be geared to problem prevention with targeted enforcement activities for non-compliance. Most importantly, the focus and clear assignment of responsibility will result in faster action to fix problems and improve the way that business is done.

Business Systems Modernization Program

The Problem

For an organization so critically dependent on technology, IRS' systems are woefully obsolete and inefficient. The facts cannot be disputed. The IRS is saddled with a collection of computer systems developed over a 35-year period. The most important systems that maintain all taxpayer records were developed in the 1960s and 1970s.

In an age of faster and more powerful computers, taxpayers are shocked to hear that their most important personal financial data is stored and updated once a week on magnetic tape. Our jury-rigged system of computers poses other problems. As *Money Magazine* observed in its April 2001 edition, “overlaying new software onto old has created a hodge-podge of data bases, many of which do not talk to one another. Until our consolidation as part of the Y2K program, there were 147 mainframes and 8,700 software products.”

The effect of this obsolete technology on service to taxpayers and productivity also cannot be disputed. As compared to what the private sector can offer, the IRS’ services are wholly unsatisfactory.

Many credit card companies and banks provide their customers with real-time account information; their phone representatives can often make adjustments on the spot. However, due to our archaic technology, IRS employees often do not have access to current taxpayer account information. Adjustments to a taxpayer’s account may not take effect for up to 16 days because of delays in updating files and data among different systems cannot be synchronized. Payments and notices cross in the mail, often generating more notices and frustration.

Indeed, the IRS has only a 40 percent rate for correctly resolving an account problem over the phone the first time e.g., a payment is not posted to a taxpayer’s account or taxpayer does not understand why he or she received a bill for an estimated penalty. Our overall account quality is improving but in this filing season is still only 70 percent

While the IRS Web site has proven to be an extraordinarily valuable source of information for taxpayers, we cannot yet use the Internet to provide taxpayers information about their returns or their tax accounts, or to exchange messages to resolve issues.

Inadequate technology and the concomitant lack of accurate data also seriously hamper our ability to identify and collect unreported or unpaid taxes. Individual audits are not started until 14-20 months after a return is filed. When they are started, the information available to our auditors is limited, extending the time to complete the audits and increasing the burden on the taxpayer. Collection of outstanding balances of individual and business taxes is extremely slow, usually taking years rather than months as in the commercial world.

The Opportunity

By taking full advantage of proven best business practices and new technology, we can greatly improve performance on all three of our strategic goals. The IRS can improve service to taxpayers and reduce their burden. The IRS can improve compliance and its collection activities, ensuring that the tax laws are fairly administered. And we can do this with limited increases in staff resources. Taxpayers will reap the benefits in a number of key areas, such as speed, access and accuracy. Let me briefly illustrate how this works in each of these three areas.

Nearly all taxpayers will be able to file and pay electronically, regardless of the type of form or tax. Taxpayers filing electronically and having correct returns would receive refunds in their bank accounts within 2 to 3 days.

We will emulate the best business practice of providing service to customers at times and through channels convenient to them, whether it is by phone, letter or on-line.

The level of phone service would increase to 90 percent. (Level of service measures the relative success rate of taxpayers who call the IRS through toll-free services and wish to speak to an operator. It excludes calls routed to automated systems.) We would expand web-based services to include exchange of information and resolution of accounts through the Internet. First time resolution of account inquires would double from 40 to 80 percent. Taxpayers would receive consistent and accurate answers to their questions regardless of the communications channel they chose. IRS employees would also have access to comprehensive taxpayer histories, thereby increasing the accuracy of the information and the transactions contained in them.

We also will provide more ways for taxpayers to resolve some issues by themselves, without requiring assistance from IRS staff. At the same time as we create the ability for taxpayers to check on such things as the status of their refunds and tax deposits through the automated systems on the telephone or the Internet, some in-person service requirements may be reduced. We are already beginning this process through such exciting initiatives as the EFTPS (Electronic Federal Tax Payment System) -OnLine program. It allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. And we have barely touched the full potential of electronic tax administration

The effect on our compliance activities would also be profound. Third party matching data would be made available earlier. Assembling all available data about a taxpayer case for our employees will avoid the need to get duplicate data from taxpayers. With the advent of many new best private sector practices, such as risk-based compliance techniques, the IRS also has the opportunity to allocate its compliance resources more efficiently, both in specific cases and around patterns of non-compliance. And when intervention is called for, we can use analytically-based techniques to assist in determining the appropriate action.

Most individual tax returns would be selected for audit within the same year and those audits will be completed more rapidly. "No change" determinations would be cut substantially.

The collection time for outstanding balances would be reduced to an average of six months. Improved systems will allow us to identify much more quickly which taxpayer accounts need attention from either telephone or in-person collectors. They will provide much more complete and accurate information to the collectors before they even deal with the taxpayer, and computer tools will assist them in closing cases.

These changes will also greatly increase our ability to "leverage" staff and use them more effectively and efficiently, while reducing the amount of time we take from taxpayers.

Our ability to ensure protection of taxpayer rights will be increased by building into the computer tools used by our employees the correct notifications and other protections prescribed by law.

The Solution

As I discussed in the introduction to my testimony, we are making substantial progress on the short-term improvement projects that support our major strategies. The other part of that dual approach is the Business Systems Modernization (BSM) program. It was established to take the IRS to the next level and make longer term, fundamental changes to our business processes and practices while managing the inherent risks of the process. Over the remainder of this decade, it will deliver the major benefits to taxpayers and our tax administration system that modernization and RRA 98 are all about. And that process has already begun.

Earlier this fiscal year, the IRS Executive Steering Committee approved the Enterprise Architecture. It is the roadmap for modernizing the Agency's business systems and supporting information technology networks. The Enterprise Architecture (Version 1.0) will guide the agency's business and technology improvements in the coming years. The approval of the architecture marks a major milestone in our progress towards the goals of Business Systems Modernization and will enable us to design and build new business and technology projects that will be the backbone of the modernized IRS.

The IRS previously published a blueprint in 1997. It was the first comprehensive view of modernized tax systems and guided the IRS in efforts to update technology. The new Enterprise Architecture reflects the lessons learned since 1997 and incorporates elements of the IRS reorganization into the four new customer-oriented operating divisions. It is an evolving document designed for constant use, with updates scheduled for spring and fall 2001 and regular updates thereafter. This new blueprint will ensure that IRS business systems' technology is compatible. And it will enable IRS employees to do their jobs better and provide taxpayers better service.

Because of the scale, complexity and risk of BSM, we can only carry out the plan by defining manageable projects, which are subject to a disciplined methodology. Each of these projects will be carried out through a step-by-step "enterprise life-cycle" in which successively greater amounts of detail are defined. The process requires that a vision and strategy phase be completed as a first step, prior to commencing tasks such as infrastructure development, information systems delivery, or process-reengineering. The final milestone in the cycle is an initial "deployment" of a project as an operational system. The IRS' Enterprise Program Management Office manages this process.

Also key to BSM's success, is the Tax Administration/Internal Management Vision and Strategy Project. Through the project, we have instituted a practice that ensures the Operating Division Commissioners and staff develop and take ownership of a process and systems modernization approach that is consistent and integrated with the overall vision of the future IRS. The project's ultimate goal is to create an enterprise-wide view of tax administration that is reflected in BSM.

The Business Systems Modernization Organization (BSMO) has now identified all the major initiatives for the next several years that link directly to our major strategies. Moreover, BSMO defined the major dependencies between and among projects and created a sequencing plan for their initiation, development, and deployment. It has also estimated the costs associated with each initiative and developed multi-year spending estimates consistent with this program. It now has a strategy for achieving the major goals of business systems modernization. The following are some of the key projects we will be working on during the next three years and beyond.

- **Deployment of the Customer Communications 2001 Project –** The Customer Communications Project is the first deployment of a business capability under the BSM effort. It is now in final testing before deployment in the third fiscal quarter. The IRS will greatly improve the efficiency and effectiveness of IRS' Automated Call Distributors (ACDs) and provide customer service levels on a par with the private sector. Hardware and software improvements will be made to the telephone system that is used to receive, route and answer more than 150 million taxpayer telephone calls each year. At a later date, Internet access capabilities will be added. This project will deliver direct benefits by increasing the number of calls that can be answered with available staff and will be a critical foundation element for subsequent projects, since virtually all major systems require communication with taxpayers.

- **Development of the Customer Relationship Management Exam (CRM Exam) Project –** Development has already begun. Through CRM, the IRS tackles some of the most complex tax calculations, including carryback/ carryforward, the Alternative Minimum Tax, and Foreign Tax Credit. This initiative will enhance the revenue agent's capabilities, reduce exam time, produce consistent results and reduce the burden on taxpayers who must deal with the IRS on these complex tax issues.

- **Development of the Security and Technology Infrastructure Releases (STIR**) – The design for STIR was approved and development was initiated. This project provides the essential underlying security infrastructure for the planned 2002 project deployments of the Customer Account Data Engine (CADE), Customer Communications (2002), and e-Services and Customer Account Management System. Development, testing and first release are expected by October 2001.

- **The Customer Account Data Engine.** (CADE) is the cornerstone of the data infrastructure. It is designed to provide a modern system for storing, managing, and accessing records of taxpayer accounts. CADE will create applications for daily posting, settlement, maintenance, refunds processing, and issue detection for taxpayer accounts and return data. The database and applications developed by CADE will also enable the development of subsequent modernized systems.

  CADE is scheduled to be released in stages, beginning first with simple tax returns being moved into the new CADE system, followed by increasingly complex taxpayer returns. As more taxpayer account information is moved into the new CADE system through these staggered releases, other modernized applications will be put in place to provide the interfaces necessary for IRS employees, and affected taxpayers, to access and carry out transactions. System development, testing and initial deployment are expected to be completed by January 2002.

- **Development of the Enterprise Data Warehouse/Custodial Accounting Project (EDW/CAP) –** Today, the IRS has a variety of dedicated research databases, and also uses its operational databases for operations research/analysis. The timeliness, consistency and standardization of the data in these separate systems do not support integrated analysis and corporate-wide decision making. The inconsistent and redundant data in stovepipe systems can result in inconsistent management and reporting data.

  Through EDW/CAP project, the IRS will develop an integrated enterprise data warehouse to support organizational data needs, such as those that are critical to managing our new compliance initiatives. For example, it will provide a single integrated data repository of taxpayer account and payment/deposit information, fully integrated with the general ledger. And it will identify payment and deposit information at the point of receipt. The operating divisions will be given access to pertinent revenue, assessment, disbursement, and seized asset information. In addition, it will provide the IRS with the capability to maintain financial controls over the $2 trillion of tax revenue received annually.

- The **e-Services** project will support our ability to meet the overall goal of conducting most transactions with taxpayers and their representatives in electronic format, as required by RRA 98. By 2002, the e-Services will: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

  An important aspect of e-Services project is that it will be one of the first projects to provide a practical and limited application to define and test the design of our critical security infrastructure for sending and receiving taxpayer data internally and externally.

- **Customer Account Management (Individual Assistance and Self-Assistance Operating Models).** In today's environment, taxpayers are often unable to receive timely and accurate responses to requests and inquiries. These operating models will provide improved technology and business processes that will enable the IRS to: better manage customer service functions; maintain and utilize customer data to improve taxpayer interactions with the IRS; provide comprehensive account and tax law assistance to taxpayers and practitioners; and manage the case work flow of customer inquiries. There is a separate release strategy for each of the operating models based on the customer segment that benefits the most from the new capabilities.

- **Tax Education (Direct and Indirect) Operating Models.** These models address improving business processes and operational systems within the pre-filing business area (*i.e.* before a return is filed). In the past, there has been minimal investment in pre-filing activities, such as making educational materials, information and forms more readily available. With the organizational modernization, pre-filing activities will become more prominent. The Tax Education Operating Models will help taxpayers reduce or eliminate errors before they become compliance problems by developing proactive and targeted educational materials that are available 24/7 in various formats from web-based products to published documents. Utilizing third-party partnerships, the IRS will develop and make available in plain language reliable educational information, guidance and advice.

- **Individual Assistance Operating Model for Reporting Compliance.** The current compliance environment has produced a number of problems, such as extended cycle times, reduced coverage and decreased customer and employee satisfaction. This project will have a significant impact on the present Reporting Compliance operational environment by providing: (1) robust, issue driven compliance planning that utilizes outcome-based improvement to ensure fair and effective selection of cases; (2) highly automated decision engines for risk-based case selection, treatment assignment and resource allocation to decrease cycle time; (3) electronic case files with pre-identified issues to support productivity gains and increased coverage; (4) case working tools, workflow management and remote access to critical data; and (5) new technology and processes to establish collectability, secure payments and facilitate payment agreements at the closure of cases. The IRS will deliver these new capabilities through four releases by 2006.

- **Filing and Payment Compliance Operating Model**. This is an end-to-end strategy to resolve collection issues quickly and fairly. It augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights at all times is an important component of this strategy. Taxpayers who are able to resolve their cases with no direct IRS contact are provided various self-correct options. Field or Collection Call center staff will assist taxpayers who need help to resolve their delinquent tax cases. They will have access to real-time data to ensure that appropriate actions are taken and taxpayer rights are protected. The operating model will decrease cycle time to approximately six months. We will deliver this operating model through four releases by 2007.

Establishing a Balanced Measurement System

All federal agencies must have appropriate quantitative performance measures. They are required by the Government Performance and Results Act (GPRA) and are essential to any large organization's proper operation. An integral part of our overall modernization program is establishing balanced performance measures that support and reinforce the IRS' mission and strategic goals. However, because of past IRS experience with measurements and RRA 98 requirements (Section 1204), developing appropriate measures is an especially sensitive and difficult task.

Critical to our efforts was establishing measurements based on what we needed and wanted to measure, rather than using what is most easily measured. Our balanced measurement system was designed to measure the progress we are making to achieve our three strategic goals: (1) service to each taxpayer; (2) service to all taxpayers and (3) productivity through a quality work environment.

Also critical is ensuring that measures are aligned at all levels, from the top of the organization to the front-line employee. This does not mean that all of the organization's levels and components have precisely the same measurements. Obviously, this would be impossible. Rather, it means that the measures or evaluations are aimed at encouraging the type of behavior that will advance the organization's overall strategic goals, and do not encourage inappropriate behavior.

In developing measures for each organizational level, it is important that each component of the balanced measurement system reflect responsibility at that level. At the top of the organization, management has control over strategies and allocation of resources. However, at the mid-level, managers have less control over these variables, but do exercise control over the effectiveness of training, coaching and guidance of employees. And at the individual level, each employee has control over his or her work and self-development.

In the balanced measures system being implemented, there will be quantitative measurements keyed to each of the three strategic goals (service to each taxpayer; service to all taxpayers and productivity through a quality work environment) at both the strategic level and the operational level. In general, quantitative measures will not be used at the individual employee level.

In September 1999, we issued a Balanced Measures Regulation to formally establish our new performance management system. The publication of the regulation, which followed a public comment period, set forth our structure for measuring organizational and employee performance.

At the strategic level, our measures are designed to gauge overall performance on accomplishing the mission and strategic goals. This level is meaningful for the IRS as a whole, or for those parts of it that are responsible for providing a full range of services to large sets of taxpayers.

We began identifying specific strategic measures in FY 2000 and will refine and finalize these measures in FY 2001. Experience has shown that the development of good performance measures is an evolving process that improves with time. Accordingly, we anticipate there may be changes to the specific measures. We expect, however, that the strategic intent behind these measures will remain firm.

At the operational management level, our measures are focused on successfully executing our core business functions within the organizational units. At this level, we derive the balanced measures of organizational performance as follows: customer satisfaction, business results and employee satisfaction. This can be easily contrasted with measuring at the individual level.

All quantitative measurements assess organizational performance, not individual performances. It is impossible to capture in any quantitative measurement system all that is important in evaluating an individual. As of January 2000, we redefined the system for setting and measuring performance expectations for nearly all managers and executives to align with the balanced measurement system.

For front-line employees, we do not use quantitative measurements to evaluate performance, except in certain submissions processing functions. In most cases, it is not practical to quantify the performance of an individual employee in a meaningful and appropriate way. Instead, we incorporate the desired activities and behavior consistent with the strategic goals into the “critical elements” of each employee’s position description.

We began to implement the balanced measures system at the operational level in 1999, starting with the three functions, Customer Service, Examination, and Collection, that most directly affected large numbers of taxpayers and employees. We implemented the operational measures for these functions within the existing organizational structure and have now transferred these measures to the new organization.

Since that time, we approved additional balanced measures for Large and Mid-Size Business, Tax Exempt and Government Entities, Taxpayer Advocate Service, Information Systems, Criminal Investigation, Appeals, and for additional Submission Processing and Customer Service product lines within the Wage and Investment and Small Business/ Self Employed Operating Divisions. We have slated balanced measures for the remaining organizational units for approval in fiscal year 2001. In the interim, we are using 64 indicative measures and workload indicators in our annual performance plan as we complete our measures development.

However, we still have work to do. We must agree on a final set of Agency-wide strategic measures and then begin implementing a comprehensive suite of strategic measures covering all taxpayer segments. Most importantly, we must continue to learn how to use balanced measures as a tool to achieve a high level of performance for all three of our strategic goals.

Development of the balanced measurement system and, even more so, learning the new ways of working will take years. By focusing our attention on what is important for achieving our strategic goals, we will stay on the right path and continue our progress.

Clean Financial Opinion as Reported by Lawrence W. Rogers, former IRS Chief Financial Officer and currently, Acting Director for Administrative Accounting, Systems and Policies

Mr. Chairman, due to the combined efforts of the IRS and the General Accounting Office, I am pleased to report that the GAO rendered an "unqualified" or clean opinion on the IRS' FY 2000 Financial Statements. This includes both the Revenue and Administrative accounts.

The GAO's opinion means that the IRS properly accounted for $8.3 billion in appropriated funds; over $2 trillion in revenues collected; and over $190 billion in refunds. In his message opening the FY 2000 Treasury Accountability Report, Secretary O'Neill stated that "Good stewardship of taxpayer resources is a responsibility I take very seriously." At the IRS, we also want to ensure that every manager and employee takes that responsibility seriously.

In fact, the success on the financial opinions can be greatly attributed to the hard work and dedication of the IRS staff; the significant improvements made to IRS' internal controls; and management focus placed on the financial audits. I would also be remiss if I did not recognize the hard work of our GAO auditors who provided us with such excellent advice.

Congress, too, has played an important role in insuring that the financial audit is an important factor when evaluating agency performance. And we thank you for your strong, vigorous and continued leadership in this area. In last year's appropriations hearings, the Chairman of the House Appropriations Subcommittee on Treasury, Postal Service, and General Government also stressed the importance of a clean financial audit for IRS. Planning is already underway to insure that we maintain the same level of commitment for the FY 2001 and all future audits.

To achieve the clean financial opinion, the IRS made significant improvements in several areas. Specifically, we:

- Implemented reconciliation procedures for IRS fund balances and ensured prompt review/reconciliation was performed;
- Revised our reporting and disclosure for the statement of net cost to properly classify IRS programs;

- Improved management of property and equipment (P&E) inventories;
- Improved our review and management of suspense accounts;
- Reduced the number of computer security weaknesses;
- Addressed issues related to safeguarding taxpayer data; and
- Improved our ability to substantiate unpaid assessments.

However, long-standing inadequacies in our financial reporting systems must still be addressed through the broader efforts to modernize the IRS' systems and organization as mandated by RRA 98. The ultimate key to better financial management at the IRS is improved technology. A complete description of our efforts and response to the GAO report may be found in Appendix A.

BUDGET SUPPORT FOR MODERNIZATION

The IRS modernization program, and particularly, Business Systems Modernization, is at a critical juncture. The President's budget request funds two major initiatives that will greatly help the IRS. First, the budget includes close to $400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

Second, the President's budget also includes follow-on funding for the STABLE initiative, begun in 2001. These funds will complete the hiring of almost 4,000 staff and will enable the IRS to address the declines in audits and the drop in customer service that have occurred over the past several years. Further details on the President's request on the IRS will be included in the formal budget transmission to occur next week.

Mr. Chairman, in conclusion, I believe that the IRS is on the right track. We have demonstrated both the ability to make some short-term improvements in service, and more importantly, the ability to produce a viable and cogent strategic plan that will guide our efforts to make changes in the entire way we do business and provide service to taxpayers. With your continued support and support of the American people, I am convinced more than ever that we can succeed.

Appendix A – 2001 Financial Audit

GAO Findings

The IRS believes that the GAO report is generally accurate and we have submitted a number of specific comments that we believe expand upon the information contained in the report, rather than challenge its findings.

Management of Unpaid Tax Assessments

First, to address the issues related to Trust Fund Recovery Penalty (TFRP) processing (*e.g.*, delays in posting, related tax liabilities, etc.) an IRS task group was established to review and recommend necessary changes. This group developed programming requirements to design an automated TFRP system that allows for systemic links. Phase I initial programming has been completed. Phase II will be implemented in FY 2002 to systematically accept downloads of data and cross-reference payments received for assessments made.

Controls over Refunds

The GAO observes that the IRS does not always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims. The IRS believes that this observation should be placed in the proper context.

The IRS has succeeded in several of its initiatives to prevent erroneous EITC refunds from being issued. Specifically, the IRS: (1) used its dependent database to identify questionable issues relating to EITC; (2) implemented the new legislation requiring re-certification before the taxpayer can claim EITC on the current tax year due to improperly claiming EITC in the previous year; (3) banned taxpayers from claiming EITC for either two or ten years after the tax year where there was a determination that the taxpayer's claim was due to intentional disregard of the rules and regulations, or fraud; and (4) implemented an automatic freeze on refunds where there is an open examination.

The results of our efforts are clear. Since 1999, the IRS worked over 55,000 re-certification cases. Our case reviews also resulted in 7,680 two-year bans and 62 ten-year bans for processing year 2000, and 337 two-year bans and two 10-year bans for processing year 2001 (as of mid-February).

Property and Equipment (P&E)

The IRS agrees with most of the GAO's comments regarding Property and Equipment. However, we do not believe that the report puts into proper perspective the substantial progress IRS achieved during FY 2000. We believe it is important to highlight the fundamental changes in the P&E management of IRS.

Prior to October 1999, there were multiple information systems organizations in IRS besides the Chief Information Officer (CIO). This was a major contributing factor to the lack of accountability and commitment in maintaining an accurate and complete Information Technology (IT) inventory, thus, resulting in the long-standing property material weakness.

Today, the IRS has one information systems organization with total responsibility for the IT inventory. Since October 1999, the Information Systems organization has made significant progress in improving how the inventory is managed and maintained.

To implement the GAO recommendation that "systems and controls be in place for FY 2000," the IRS devoted P&E employee resources to undertake and accomplish the task. The IRS had already established the Financial and Management Controls Executive Steering Committee (FMC ESC). It is chaired by IRS Deputy Commissioner Bob Wenzel and is the major coordination point in the IRS for improving financial management systems. The FMC

ESC established the Property Subcommittee, consisting of executives of the offices of the CIO, Chief Financial Officer (CFO), and Procurement. This Subcommittee met weekly and made decisions to ensure systems and controls for P&E were developed and functioning for FY 2000 and the future. This Subcommittee will continue to function until all property issues are resolved.

The IRS also established the Asset Management Modernization Project Office whose full time job is to implement industry "best practices" and deploy new automation tools. A complete discussion of these and other improvement projects can be found in our response letter.

In summary, we believe that through the major automation and process improvements I have outlined, the IRS significantly reduced the long-standing material weaknesses identified by GAO. With continued executive support and dedicated staff resources, the momentum attained to date can be sustained, and the underlying deficiencies in IRS' property management eliminated.

Manual Tax Receipts and Taxpayer Information

On October 30, 2000, the IRS established a Subcommittee on Security under the FMC ESC. The Subcommittee provides an agency-wide senior executive forum to address, and to make decisions on, security policies and priorities. It focuses on efficiently and effectively implementing and communicating these policies and priorities throughout the IRS. The Director of the Office of Security is the Chair of the Subcommittee.

Computer Security

Recognizing the critical need to enforce federal law and regulations concerning privacy and non-disclosure of confidential tax information, the IRS created the Office of Security to establish and enforce standards and policies for all major security programs including, but not limited to, physical security, data security, and systems security. The OS provides the IRS with a proactive, independent security group that is directly responsible for the adequacy and consistency of security over all IRS' operations.

Our security approach is consistent with GAO's September 1996 report, *Information Security: Opportunities for Improved OMB Oversight of Agency Practices*, which noted that, "Such a program can provide senior officials a means of managing information security risks and the related costs rather than just reacting to individual incidents."

Using a security framework, we are setting priorities for resources and we are measuring and demonstrating success in improving the overall security posture of the IRS. We are also taking a proactive approach by conducting security reviews at the computing centers and campuses. Our Office of Security works closely with local and Headquarters management to develop solutions, monitor implementation, and conduct on-going reviews to ensure weaknesses do not recur.

Revenue Reporting and Distribution

In its report, GAO notes that there are continued weaknesses in fundamental internal controls. To address this issue, the IRS implemented procedural changes to ensure expedited processing of million-dollar returns. We also provided procedures to monitor timely posting of returns and to identify taxpayers who had not yet filed their returns. This will ensure processing prior to the end of the certification period.

The GAO also noted there was a delay in posting to the Highway Trust Fund and the Airport and Airway Trust Fund in the amounts of $346 and $34 million, respectively. There are three reasons why amounts received in a quarter are certified in a subsequent quarter: (1) late filed returns; (2) processing delays (lack of documentation, etc); and (3) subsequent activities. In the above cases, we needed additional documentation and returns were filed late. It should be noted that there is no penalty for late filing provided the taxpayer has submitted his or her payment on time.

IRS' Structuring of Installment Agreements and Compliance with the Internal Revenue Code

The IRS has made considerable improvements on the structuring of installment agreements. In FY 1999, twenty percent of the unpaid cases examined were non-compliant with the Code. In FY 2000, the non-compliant percentage dropped to two percent. To ensure that agreements are compliant, the IRS issued guidance to its employees. We are also developing training on processing new installment agreements.

Furthermore, the IRS is revising its guidelines to reemphasize the necessity of ensuring that installment agreements cover all outstanding taxes. If this cannot be accomplished, the case will then be handled in accordance with Offer-in-Compromise procedures. The IRS will also continue to monitor and enforce the guidelines on installment agreements.

Federal Tax Liens

The GAO has noted significant improvement in the IRS' processing of federal tax liens. To better refine the processing of liens, the IRS: (1) issued guidance to its employees and provided additional training; (2) instituted monitoring and enforcement of the processing guidelines for liens; and (3) centralized the control of the federal tax lien process to one site. Previously, the process had been decentralized to each of the 33 IRS districts.

Long-Term Efforts

A major concern shared by the IRS and taxpayers is privacy and security, both internal and external. Let me restate the IRS' commitment to recognizing taxpayer privacy to the maximum extent possible in all Service initiatives. Given the vulnerability of modern electronic information systems to cyber attacks, hacking, and natural disaster, we are focusing resources on risk management processes, secure messaging and authentication, physical security, cyber attack response capability and disaster recovery measures.

The IRS will make substantial progress in improving its stewardship of assets over the next two years, although much more will be possible through our longer-term business system modernization efforts. The following are some of the ways we will implement this strategy.

Privacy

The IRS will incorporate privacy protection principles into all of its programs and policies. We will enhance the privacy impact assessment methodology, applying it to all stages of a system's development and requiring it as a part of a system's certification.

Security

The IRS will establish a Critical Infrastructure Plan to ensure that information systems critical to the financial security of the United States survive. The IRS will also continue to work with the computing centers to enhance their physical security to Level V, the Department of Justice's highest physical security designation. In addition, we will assist service and computing centers in conducting integrated disaster recovery exercises. Furthermore, the IRS will review the state of its security and focus on providing solutions to identified vulnerabilities and completing security certifications of sensitive systems. The IRS will bring the Computer Security Incidence Response Center to full operational capability and will provide oversight of selected IRS program areas to ensure practices are consistent with policy and guidance.

Property Management (IT)

The IRS will enhance and enforce policies and procedures to ensure accountability for use of information technology (IT) property. There will also be a transition from the current internally developed IT property tracking system (Integrated Network and Operations Management System – INOMS) to a Commercial Off-the-Shelf (COTS) solution. The IRS will connect the IT asset system with the non-IT property management so there is one comprehensive property system throughout the IRS

Financial Systems

The IRS will implement a Joint Financial Management Improvement Program (JFMIP) approved financial management system. We will select a COTS product that best satisfies our internal management needs through an enterprise resource-planning product. Our first phase of implementation will be replacement of the core financial system, with planned future implementation of other internal management modules.

Strategic Plan

The Strategic Plan stresses that the IRS must demonstrate effective stewardship of the assets and information entrusted to it by improving our internal processes for information management, financial management, and asset management.

Conclusion

To summarize, the Internal Revenue Service is committed to improving financial management. We view all of these actions as necessary to build upon current processes and systems to provide the best financial information possible that meets statutory and policy requirements. Additionally, it must be stressed that the long-term solution to many of the issues identified through the audit process can only be addressed by the design and implementation of new or enhanced automated systems that will be developed over the next several years.